

October 19, 2006

HONORABLE MAYOR AND CITY COUNCIL:

As this 2006-2007 Adopted Operating Budget was being prepared, the City of San José found itself at a critical juncture. We continued to confront the need for significant budget reductions. In fact, this year represents the fifth consecutive year in which the Adopted Budget contained multi-million dollar reductions in the City's General Fund, and the City's Five-Year Forecast contained continued shortfalls for each of the next five years. This year was different from previous years, however, in that there were solid indications that a steady, albeit slow, recovery is finally underway in the local economy. Despite this modest turnaround, however, it is also critical to note that for this year and the foreseeable future, our projections indicate that even in this improving fiscal environment, projected growth in revenues will not be sufficient to meet expenditure obligations, both for existing programs and for new operating and maintenance costs that accompany our *Decade of Investment* capital improvement program. As would be true at the start of any period of economic recovery, but particularly in light of our structural deficit situation, it was now therefore more critical than ever that we resist the temptation to add resources beyond those that our existing revenues will support. A careful reading of this adopted budget document will reveal the strategic addition of resources to address critical service and infrastructure needs. However, it will also reveal that we have only avoided more significant and severe budget cuts through the approved extension of the Emergency Communication System Support Fee, which provides approximately \$20.6 million annually to the Operating Budget.

As we entered this fifth year of budget deficits, it remained an extraordinary accomplishment that to date the organization has avoided more serious reductions. Nevertheless, the reductions we have experienced since 2001, which totaled more than \$260 million, have not come without a cost. Critical infrastructure needs have been postponed, and while the workforce has shrunk by 741 positions, few programs have been eliminated, requiring the existing workforce to do more with less. This approach simply cannot be sustained without serious consequences. Infrastructure maintenance needs that are left unattended will lead to far more expensive repairs down the road. A workforce asked to do too much with too little will make mistakes, and employees will seek better work environment elsewhere. These are unacceptable propositions, and the City Council will find actions in this Adopted Budget for cautious investment in both infrastructure and personnel.

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As a result, this Adopted Budget reveals the odd juxtaposition of two apparently conflicting messages. On the one hand, we continued to face significant funding shortfalls for the foreseeable future, and while revenues are growing modestly, the pace of this growth is simply not enough to keep up with the expenditures that are necessary to meet existing obligations. On the other hand, due to conservative budgeting practices and a modestly improved economic picture, we were in a position to utilize one-time revenue overages and expenditure savings from the current year to strategically add resources to begin addressing critical current and future needs.

The actions in this budget were based on the underlying assumption that the economic environment in the region will neither return to the extremely high growth levels experienced in the late 1990s nor drop back into the recession conditions that so devastated City finances in the first four years of the new decade. While the Valley economy and the associated City revenue performance are expected to resume modest growth, as noted earlier, expenditure levels of existing General Fund programs are expected to exceed those revenue growth rates.

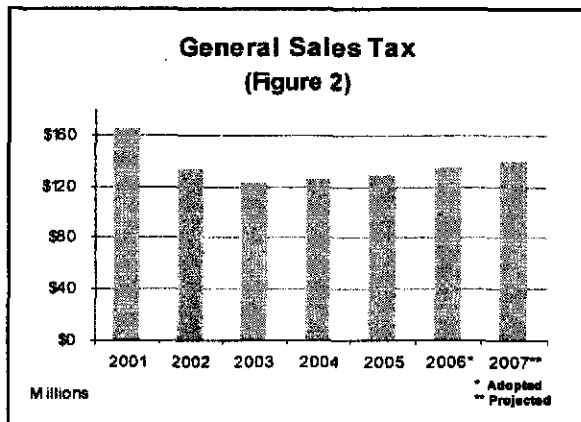
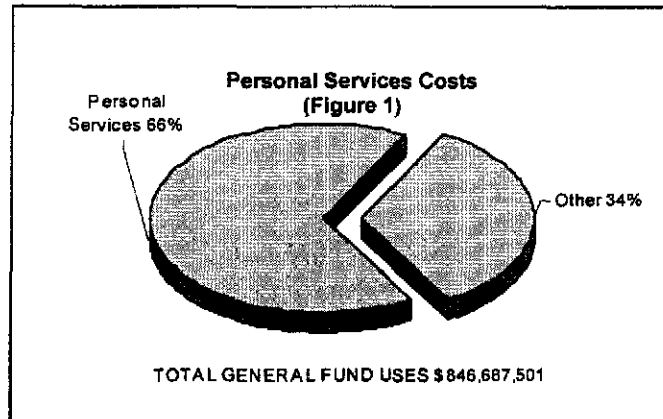
Despite the ongoing fiscal challenges, the adjustments in this Adopted Operating Budget continue to focus on City Council priorities, directing resources toward essential services, basic infrastructure requirements, economic development opportunities, and maintaining the City's strong commitment to neighborhoods. As a result of the improving economic picture and in recognition of the City Council's long commitment to supporting our community partners, the actions in this Adopted Budget do not reduce funding to Community-Based Organizations (CBOs) equal to the average of the non-Public Safety reductions as has been the case for the last several years. Instead City Service Areas (CSAs) continue to focus resources on core functions and reductions were minimized through the strategic use of one-time dollars. For the fourth time in as many years, approved reductions were divided between Tier One, consisting of adjustments to be implemented immediately, and Tier Two proposals that, in this case, was primarily aimed at addressing the potential impact of not extending the Emergency Communication System Support (ECSS) Fee beyond the current 2006 sunset date. As the ECSS Fee was approved to be extended with its sunset now scheduled for June 30, 2009, the Plan would be recommended for use for any other development during the year that caused the General Fund budget balancing strategy to require additional expenditure reductions. The reductions contained in the *2006-2007 Emergency Communication System Support Fee Contingency Plan* can be found in a separate section toward the back of this document.

Our ability to sustain services through the long recession has rested on the conservative fiscal policies adhered to by the City Council and the organization over the past four years—a commitment we must maintain again this year. As we have in years past, this year we imposed Cost/Position Management Plans to reduce the impact of the anticipated General Fund shortfall by requiring every General Fund department to meet a savings target in the current fiscal year. This effort resulted in additional savings of \$6 million to help balance the 2006-2007 Operating Budget. We also continued the freeze in hiring for non-critical positions, first imposed in 2001, with the desired effect of reducing expenditures and preserving vacancies to avoid lay-offs as services are reduced or eliminated. While these strategies will be familiar to anyone who has followed the City's budgeting efforts since 2001, another trend of the past four years was reversed in this budget with the approval of a modest increase in our overall employee count. Since 2001, the number of City employees has steadily decreased from a high of nearly 7,500 employees, to 6,672 in the current budget year, roughly the same number of employees as in 1999. With the 2006-2007 Adopted

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Budget, the number of positions will increase by 172 to 6,843. The majority of new positions, 83 in all, are being driven by staffing requirements in bond-funded facilities that will be brought on-line in 2006-2007.

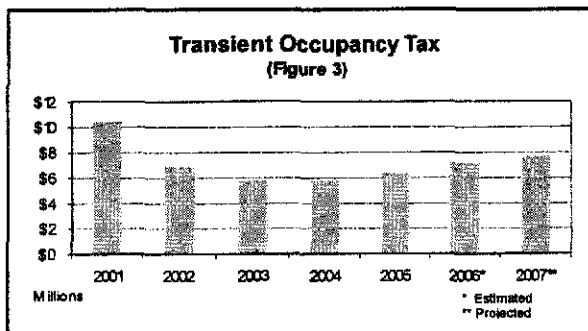
While the ability to add some staff is a welcome change, as discussed above, the City continues to confront a structural problem in the General Fund with expenditures exceeding revenues in each year of the Five-Year Forecast. While nearly all City employees partnered with the City in holding salaries down at the worst of the recession, upward pressure has now resumed, and the City cannot expect to attract and retain employees if salaries lag behind those of surrounding agencies. As shown in the Personal Services Costs chart (Figure 1), two-thirds of the General Fund costs are directly tied to personnel costs.



All of the expenditure management actions implemented in past years have been continued through the 2005-2006 Fiscal Year. In addition to the Hiring Freeze and Cost/Position Management Plans cited above, we have continued expenditure controls on technology, marketing, travel and vehicle purchases first imposed in 2003, and have continued to offer a Voluntary Furlough and Special Reduced Work Week program, which this year saved \$1.1 million. Total General Fund revenue projections (excluding fund balance) in the 2005-2006 Adopted Operating Budget were

\$682.8 million and for 2006-2007 current projections place the base budget revenues number at \$711.9 million a 4.3% increase. While a full review of the City's current and projected fiscal picture is detailed in the *General Fund Balancing Strategy Detail* (Attachment A), some noteworthy trends are highlighted here. Sales tax revenue (Figure 2) is showing moderate growth of 6.5%, and the Transient Occupancy Tax (Figure 3), which is tied to revenue from local hotel bookings is projected to grow by nearly 18% (however, growth of only 7% from the 2005-2006 year-end estimate is anticipated). Property tax revenues also remain extremely strong, showing growth of almost 28%.

The size of the Property Tax growth is somewhat misleading, however, because it includes the return to the General Fund of an \$11.1 million revenue stream that for two years was diverted to State coffers and the one-time impact of the VLF Swap true-up. Without this change Property Tax



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revenues are projected to grow by approximately 12.5%. Unfortunately, as a consequence of the softening real estate market, the forecast for future Property Tax revenue is for significantly lower growth.

In recent years San José has been very prudent in its use of reserve funds, and it is important to note that this cautious approach is one of the key factors that has allowed San José to sustain a strong AA+ bond rating. This rating is still the highest of any major California city and has translated directly to the City's bottom line by keeping interest rates low when we borrow money.

With the slow emergence from the deficit now clearly underway, it would be tempting to loosen the tight fiscal discipline that has guided our budget efforts through the downturn. Until we see economic growth sustained for a couple of years, however, we should continue to act prudently and dedicate one-time dollars to meeting two critical needs: 1) infrastructure maintenance costs that have grown significantly over the past five years; and, 2) emergency reserves in the event of another slow-down triggered by rising costs for fuel, as well as personnel costs such as health and retirement. The City Council approved the use of one-time dollars to replenish our Economic Uncertainty Reserve through the addition of \$3.3 million in one-time current year fund balance funds, and the funding of \$5.3 million to address the *Transportation Infrastructure Maintenance Backlog* from the same source. While the creation of such a transportation infrastructure reserve represents a good first step, this amount pales in comparison to the outstanding needs for pavement repair and other transportation infrastructure improvements that have been identified. Readers will also find smaller allocations established to begin addressing unmet technology needs (\$3.5 million) as well as facility infrastructure maintenance (\$1.0 million).

ECONOMIC OVERVIEW

As is the case every year, the most significant challenge the Administration faced in formulating a budget for the coming year was projecting the condition of the local economy and the associated level of revenue collections. Monitoring of revenue collections through the first eight months of the year have confirmed the general accuracy of the key assumptions used to build the *2005-2006 Adopted Budget*: 1) that the severe downturn experienced over the last four years has bottomed out; 2) that the local economy has begun to experience modest economic growth; and 3) that there is little chance for a resumption of the levels of growth experienced just prior to the crash of 2001-2002. As a result, by taking a conservative approach in our budget projections, the 2005-2006 General Fund revenue collections, particularly in our economically sensitive categories, generally ran at or above budgeted levels.

Revenue estimates for 2006-2007 have been built on two overriding basic assumptions: 1) that the economy at the national, state and local level will continue to exhibit growth, but that growth will be down slightly from that experienced this year; and, 2) that we will continue to experience approximately the same current modest growth levels in our local revenues for the next full fiscal year.

The first assumption reflects the consensus of most forecasters as they look at the National and State economies. Predictions are for continued growth but at a reduced level due to three factors:

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ECONOMIC OVERVIEW (CONT'D.)

1) spiking oil prices; 2) a slowing housing market; and, 3) the continuing rise in interest rates engineered by the Federal Reserve Board. Consumer spending is 70% of the national economy.

The single biggest reason the last recession wasn't worse, was the willingness of consumers to continue to spend in spite of the tough economic conditions. We share the belief of most economists that the state of consumer confidence and associated spending rates will be negatively impacted to some extent next year, the result of both rising energy costs that are taking increasing amounts of dollars out of consumer's pockets, and the cooling housing market. One economic expert, Joseph Stiglitz, professor at Columbia University and winner of the 2001 Nobel Prize in economics, describes well the expected impact of the housing market downturn: "We've been sustaining consumption by taking money out of housing. As the housing market slows, we will not be able to maintain the increases in consumption that we need to sustain growth at 3 or 4% a year."

A more significant concern, particularly for California and the Bay Area is the risk of a fall in housing prices that is more precipitous than the current relatively moderate rate of decline. There is a fear among an increasing number of economists, that five straight years of record home sales, fueled by the lowest mortgage rates in recent history, spurred a speculative fever in housing similar to the forces that created a bubble in stock prices in the late 1990's. These economists see a crash in home prices as one of the biggest threats to economic growth, and the areas at greatest risk are areas such as California, Nevada, and Arizona which have the hottest home sales markets. We will continue to monitor this closely.

As to expectations for the Local Bay Area and Silicon Valley economy, it is encouraging that the significant drop in revenue suffered over the prior four years has now stabilized, and modest growth in our economically sensitive revenues has resumed. Although the growth rates now being experienced appear sustainable, subject to the risks described above, we still find no substantive reasons to believe that the levels of growth will exceed the current modest levels for the near term.

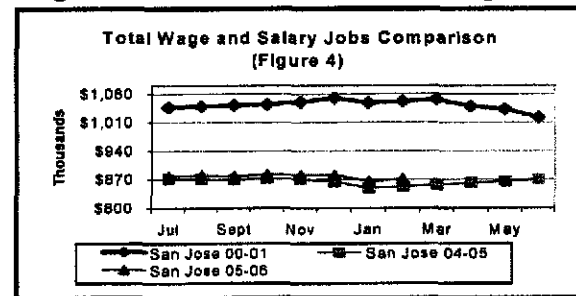
Among our two largest General Fund revenue sources, Property Taxes have exceeded expectations, not only this year, but for the past several years, due to the fact that the local real estate market has sustained levels of growth higher and for longer than expected. Since Property Taxes for 2006-2007 will be based on the calendar year 2005 tax rolls, the City is likely to see at least one more year of solid growth in this area even as local housing growth slows. Our revenue estimates for the 2006-2007 Adopted Budget in this category reflect that expectation. Following four years of poor performance, the most economically sensitive revenue we rely on, General Sales Tax, is now also experiencing steady growth. That growth, has however, been much more unpredictable, with strong quarterly growth reports being followed by quarters where growth was virtually nonexistent. In the most recent two quarters, for example, growth of 14.5% in the first quarter of the year was followed by a second quarter where growth of just 2.3% was experienced. Our expectations for next year are for modest growth in this our second largest General Fund revenue source, with a projected growth rate of 3% over the 2005-2006 estimated level.

Since the beginning of the economic downturn, however, it has been our consistent belief that the most reliable predictor of local economic improvement is the local jobs picture. While the

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ECONOMIC OVERVIEW (CONT'D.)

employment situation has stabilized and there are even some signs of small increases, as this budget was being prepared we were still seeing no signs of a significant rebound. The very slight growth experienced over the last several months has recovered only a small fraction of the more than 200,000 jobs that were lost locally during the recession. In fact, as far as the employment picture goes, we still seem to be living in a period of two separate economies, the National/State economy and the local economy, which are experiencing vastly different employment scenarios. Job growth nationwide and at the State level resumed at relatively healthy levels over the past 12 months. More than two million jobs were created at the national level, and over 190,000 jobs created in California. By comparison, local job growth continued to lag. June employment data, confirmed that situation as unchanged at that point. The valley gained a miniscule 6,100 jobs between May 2006 and June 2006, and lost 900 jobs between December 2005 and June 2006. Although year-over-year employment for the period of June 2005 to June 2006 saw an increase in overall jobs, that increase was minimal -- just 4,000 or 0.5%. Absent clear signs of vigorous growth in this area, believed it prudent to assume only modest growth levels in the local economy and in local revenues in the 2006-2007 Adopted Operating Budget.



OPERATING BUDGET OVERVIEW

In the 2006-2007 Adopted Operating Budget, the total net adopted funding is \$3.01 billion for all City funds (General, Special, and Capital). This is \$347.3 million or 13% higher than the 2005-2006 Adopted Operating Budget (Table 1 below). As noted above, the total number of positions increased by approximately 3%, to a total of 6,843.

2006-2007 ADOPTED BUDGET — ALL FUNDS (Table 1)			
	2005-2006 Adopted	2006-2007 Adopted	% Change
General Fund	\$ 841,688,233	\$ 956,829,159	13.7%
Special Funds	\$ 1,228,838,694	\$ 1,328,053,677	8.1%
<Less: Operating Transfers>	(\$567,501,127)	(\$645,998,184)	13.8%
Net Operating Funds	\$ 1,503,025,800	\$ 1,638,053,652	9.0%
Capital Funds	\$ 1,168,675,771	\$ 1,383,338,546	18.4%
<Less: Capital Transfers>	(\$7,176,000)	(\$10,388,000)	44.8%
Net Capital Funds	\$ 1,161,499,771	\$ 1,372,950,546	18.2%
Net Total	\$ 2,664,525,571	\$ 3,011,835,198	13.0%

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OPERATING BUDGET OVERVIEW (CONT'D.)

The General Fund portion of the City's Budget will increase by 13.7% from 2005-2006, and totaled \$ 956.8 million.

Budget Balancing Strategies

Our earliest projections for 2006-2007 predicted a \$76 million shortfall nearly half of which (\$31.2 million) resulted from the use of one-time dollars to balance the 2005-2006 Operating Budget. As we entered the fifth straight year of significant funding gaps, cost management controls that once seemed extraordinary were now integrated into the day-to-day operation of the City. In October, the City Council established a 2006-2007 Future Deficit Reserve by setting aside \$12 million of year-end fund balances during the final reconciliation of the 2005-2006 Budget. Cost/Position Management Plans, that the Administration imposed in October, yielded an additional \$6 million in savings for the fund and translated to a 1% reduction for Public Safety and a 2% reduction for all other CSAs. In February, the Five-Year Forecast showed an improved picture with the projected General Fund shortfall dropping by \$40 million. Two factors contributed to this drop. First, the actual cost of the Police/Fire Retirement Fund for 2006-2007 was \$25 million lower than the rate projected earlier by the Actuary. Second, an improving economy increased revenue projections by \$15 million. Further refinement of revenue and expenditure projections explained in detail later in this document resulted in a final General Fund shortfall in this Adopted Budget of \$35.9 million.

In developing the 2006-2007 Adopted Operating Budget, the Administration once again focused City resources on vital core services and Council priorities. Each CSA including Public Safety was required to propose reductions and revenue enhancements. In recognition of the City Council's commitment to maintaining public safety as its top priority, the Public Safety CSA reductions were kept to a minimum, resulting in more severe service reductions in all other CSA's.

In preparing the 2005-2007 Adopted Operating Budget, the Administration was guided by a set of principles and strategies contained in the City Manager's Budget Request and adopted by the Council in the Mayor's March Budget Message. This budget also responded to the 114 directives contained in the Mayor's March Budget Message with descriptions of how the budget responded to these directives (Attachment B to this message). A total of 23 of these directives were responded to through the Manager's Budget Addenda process.

The resulting 2006-2007 Adopted Operating Budget included some ongoing cost reductions, prudent fee increases, the extension of the critical ECSS Fee, the inclusion and conversion to ongoing of the Cardroom Business Tax revenue, and once again the strategic use of reserves and one-time revenues. The table on the following page shows the matrix of balancing strategies and the dollars associated with each action. In addition, a total of \$103 million was rebudgeted from unexpended 2005-2006 funds that would allow for the completion of prior year projects and activities.

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OPERATING BUDGET OVERVIEW (CONT'D.)

Tier One General Fund Budget Balancing Plan (Table 2)	
	In \$000s)
General Fund Shortfall	(34,890)
SOURCE OF FUNDS	
2006-2007 Future Deficit Reserve (one-time)	18,426
Emergency Communication System Support Fee ¹	10,357
Cardroom Revenue	9,500
Unrestricted Fund Balance	6,261
e-Government, Fee Program and Other Earmarked Reserves	4,793
Transfers from Other Funds	3,424
Miscellaneous	3,913
Total Change in Source of Funds	56,674
USE OF FUNDS	
Staffing and Non-Personal/Equipment Reductions	(5,404)
Funding Shifts	(2,096)
Use of Reserves (Committed Additions)	(4,011)
New Facilities (Operations and Maintenance)	4,082
City Council Direction (Mayor's Message)	5,914
Technology and Capital Infrastructure Funding	9,800
Economic Uncertainty Reserve	3,278
Public Safety Additions	2,569
Miscellaneous Additions	7,652
Total Change in Use of Funds	21,784
Total Balancing Solutions	34,890

The improving economic picture has significantly reduced the need to eliminate positions as a part of the 2006-2007 balancing plan. While the ability to strategically restore some positions is good news, there are still real reductions and employee impacts in this budget. As shown in the table below, actions in the Adopted Budget (Tier 1) resulted in the elimination of 40 positions and the addition of 219 positions, for a net increase of 179 positions.

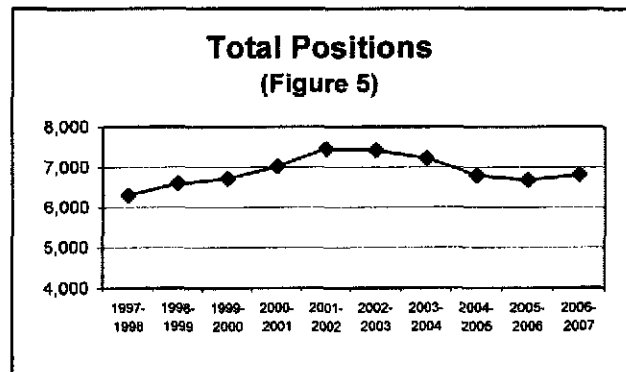
Changes in Position Count from Forecast to Adopted (Table 3)			
	Tier 1	Tier 2	Total
Reductions	(40.20)	(106.60)	(146.80)
Additions	219.34	0	219.34
Total	179.14	(106.60)	72.54

¹ ECSS Fee was scheduled to sunset on December 31, 2006. This action recognizes the extension of the fee, adding half year revenue for 2006-2007 (\$10.4 million), and full annual revenue of \$20.6 million ongoing for future years.

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OPERATING BUDGET OVERVIEW (CONT'D.)

Of the 40 positions approved for elimination in the Adopted Budget, however, only one will need to be redeployed to another classification and we are confident that a position can be found for that employee. If Tier 2 actions are necessary, however, the number of position eliminations increases dramatically, with an additional 107 positions cut. As indicated earlier, the total number of positions grow approximately 2.6%, to 6,843, in 2006-2007. As Figure 5 demonstrates, even with the approved additions, the total employee count is still only roughly equivalent to our 1999-2000 employee count. Since 2002 when the harshest impact of the economic downturn hit the City budget, the net reduction of City positions totals 609, a decline of approximately 8%.



Similar to other recent budgets, the 2006-2007 Adopted Operating Budget was balanced with assumptions about things that have yet to occur, but which could have significant impacts on this Adopted Budget. Chief among these was the proposed extension of the Emergency Communication System Support Fee that was recommended as part of the Proposed Budget development process. If Council had not approved this extension as they did, there would have been a \$10.4 million hole in the budget, and a \$20.6 million annual problem in the future. Because of the fee extension approval, the Tier Two *Emergency Communication System Support Fee Contingency Plan* was not implemented at this time, but a review of this list reveals that virtually every CSA except the Environmental & Utility Services CSA would have been impacted. Another problem that could trigger the consideration of Tier Two proposals, however, would be unanticipated compensation increases resulting from the still unresolved bargaining unit agreements.

Fee & Rate Increases

The City's fee-based programs have real and direct benefits to the community. Fees paid by developers lead to better service levels, facilitating smoother transactions. Fees paid to support our Recycle Plus program have made San José a national leader in this area. The long-standing practice with fees has been that fee programs should be self-supporting to avoid a drain on the General Fund. For the past several years, however, we have avoided or minimized a number of fee adjustment to soften the impact on fee payers. As expenses continue to rise, however, an unavoidable consequence of postponing increases is that larger adjustments are required later. While it may be tempting to put off the difficult decision to raise fees, taking the long range view leads to the conclusion that more frequent but smaller increases in fees is a prudent approach.

As noted earlier, the extension of the Emergency Communication System Support Fee was a critical part of the balancing strategy contained in the 2006-2007 Adopted Operating Budget. While no increase was approved in the Fee, Council retained the fee and re-established its sunset date for June 30, 2009. In addition to being an integral part of the budget balancing strategy, this action enabled

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OPERATING BUDGET OVERVIEW (CONT'D.)

Fee & Rate Increases (Cont'd.)

the City to add six new Public Safety Dispatcher positions needed to address a 13% increase in overall call volumes resulting from the transfer of responsibility for answering wireless 9-1-1 calls from the California Highway Patrol to the City's Communication Center.

In the Community and Economic Development CSA, a package of fee increases implemented between 2002-2003 and 2004-2005 greatly increased the financial stability of the development service partners in this CSA. For 2006-2007, however, Public Works, Building and Planning had projected cost recovery shortfalls ranging from 5.4% to 11.7% and the combined 2006-2007 base shortfall for the development service partners was approximately \$3 million.

To address these issues, discussions were initiated with industry groups about desired service levels and the possibility of a four-year phased fee increase package based on a balanced fee program with clear cost/service impacts. The Adopted Budget includes fee increases of 7% for Building, Planning and Public Works, and a 4.5% increase for Fire in 2006-2007. The development services package also included the addition of two positions each for Fire, Public Works and Planning to address performance and an additional engineer for Building to improve consistency and customer service. In addition, implementation of an Industrial Tool program has resulted in the addition of a position in Fire and two in Building.

In the Environmental & Utility Services CSA, it remains a continuing strategic objective to achieve and maintain 100% cost recovery in the various special funds to ensure financial integrity and fiscal responsibility of funds.

The utility infrastructure in San José – the sanitary sewer system, storm sewer system, wastewater treatment plant, and water distribution system – is aging and requires increased maintenance. The problem is most critical at the Water Pollution Control Plant, where more than \$250 million in rehabilitation and replacement projects have been identified as necessary over the next 10 to 15 years. The City also is entering the final year of its NPDES (National Pollutant Discharge Elimination System) Storm Permit and beginning development of the permit for the next five-year cycle, which is expected to be a very complex and costly bay-wide regional permit. Finally, the City must comply with its NPDES Treatment Plant Discharge Permit, perform technical studies and achieve continued compliance with the recent Administrative Order from the U.S. Environmental Protection Agency. Approved in the budget, therefore, were 4.5% increases in the Sewer Service and Use Charge Fund and the Storm Sewer Operating Fund.

A 4.3% increase was also approved for the Municipal Water System, to cover the increased cost of purchasing wholesale water from the Santa Clara Valley Water District and the San Francisco Public Utilities Commission. These costs have escalated significantly in recent years due to the need by these two agencies to fund major capital improvements to their systems and to meet more stringent water quality standards.

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OPERATING BUDGET OVERVIEW (CONT'D.)

Fee & Rate Increases (Cont'd.)

In the Integrated Waste Management Fund, expenditures increased 7.3% in 2005-2006. Additional increases are anticipated in future years due primarily to fuel and labor costs, landfill disposal costs, and the need to prepare for unknown future contract costs starting July 1, 2007. In 2005-2006, Council conceptually approved a 3-year plan of rate increases to cover these costs. Council approved an increase effective April 1, 2006, of 5% for single-family households and 3% for multi-family households for the first year of that plan. This Adopted Budget included implementation of year two of the plan, with increases of 5% for single-family households and 3% for multi-family households. Under the plan, a similar rate hike would be proposed for next year, but increased fuel costs and the potential of higher costs in a new hauler contract could require a greater increase.

Additionally, a 14.2% increase in Commercial hauler fees was approved to ensure a higher level of cleaning activities on an interim basis in downtown while a long-term strategy for a "Clean and Green" downtown is prepared.

City Service Areas (CSA)

The following section highlights the most significant changes for each of the City's CSAs. A more detailed recitation of the changes for each CSA can be found in the detailed budget pages following this message.

Community and Economic Development CSA

Because the lack of a more robust growth in economically sensitive revenues continue to constrain the City's operating budget, it was appropriate that the adjustments for the Community and Economic Development CSA continued to focus aggressively on implementation of the City's Economic Development Strategy. These actions are in direct alignment with the priorities identified by the City Council:

- Attract and retain retail business to provide San José residents with more convenient services and help overcome San José's high retail leakage to other communities with a particular emphasis on the automobile sector and the expansion of new and existing major retail centers;
- Communicate a compelling community identity to raise the image of San José in concert with and in support of our leading corporations and San José State University;
- Facilitate job and revenue generating company expansions and relocations and new housing development to provide the City with a competitive edge as a global economic center (e.g., the implementation of the North San José Development Policy);

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OPERATING BUDGET OVERVIEW (CONT'D.)

City Service Areas (Cont'd.)

Community and Economic Development CSA (Cont'd.)

- Encourage the development of cultural and sports events (e.g., ZeroOne Festival, Grand Prix, Tour of California, Rock and Roll Half Marathon) and the repositioning of existing events (e.g., Jazz Festival, Cinequest) to generate additional revenues, foster a dynamic quality of life and to enliven the City's national and international image; and
- Expand efforts in museum/cultural growth, partnerships with San José State University, attraction and retention of businesses, and diversification of the economic base.

In this Adopted Budget, four positions added last year to the Office of Economic Development (OED) will be made permanent to address several Economic Development initiatives. They will assist in: 1) raising the image of San José as a destination; 2) attracting additional retail business; 3) increasing tourism money by encouraging sporting teams, events and facilities to locate in San José; and, 4) supporting development facilitation. Three of the positions are Economic Development Officers, one of whom will focus on communications. The fourth position is an additional Senior Events Coordinator in the Cultural Affairs division of OED to address increased special event activities such as community outreach, business involvement, traffic mitigation and multi-agency coordination.

In the area of events, the Sports Development Fund within OED was made permanent and funded at \$350,000 for 2006-2007 to support the initial phases of new events. OED will partner with the Sports Authority to provide resources to help attract Olympic and NCAA championship events when appropriate. No budget reductions were approved for either the Sports Authority or the Arena Authority. A \$100,000 allocation was approved to support the use of City facilities during the ZeroOne Festival (August 2006) which has received financial commitments from private and non-profit organizations in excess of \$1.8 million. No budget reductions from 2005-2006 levels were approved for local small business chambers of commerce and the Convention and Visitors Bureau, enabling these organizations to engage in significant outreach and marketing activities to drive local economic activity.

The Silicon Valley Workforce Investment Network (SVWIN) program will shift to a greater reliance on permanent staff, significantly reducing the use of temporary unclassified employees. The program will continue to offer universal services to its clients through a reconfigured set of one-stop locations in Midtown and East San José, Morgan Hill and Gilroy. Not only will this new one-stop configuration result in more convenient and spacious locations, the substantial rent savings will be reinvested in client services.

In advancing this CSA's core service of building safe, healthy, attractive and vital communities, the Planning, Building, Public Works and Fire development services partners are focusing on restructuring service delivery to match the needs of specific customer groups, adding certainty to the development process, and improving the customer experience. Several investments were approved to achieve these goals and simultaneously respond to City Council direction through the Getting

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OPERATING BUDGET OVERVIEW (CONT'D.)

City Service Areas (Cont'd.)

Community and Economic Development CSA (Cont'd.)

Families Back to Work and Counter-to-Council initiatives. To match staffing with activity levels and meet the needs of targeted customer groups, augmentations in the Adopted Budget were approved that will add two Fire Engineers, allow overtime funding for plan review, shift Public Works engineers to the fee program, and add two planners for the permit center. To add certainty to the development process, a Building engineer position was added to coordinate with the inspectors. Improving customers' experience entails hiring a webmaster for the new Development Services Web portal and making physical improvements to the customer service areas in City Hall. In an effort to meet the needs of high tech and other industrial operations, the creation of the Industrial Tool Program was approved. This program was developed in response to concerns expressed by local companies, and was designed in collaboration with these customers. A new position in Fire and two in Building to respond to an increase in volume and staff-intensive focused team approach were approved for this new program.

To achieve these goals we must maintain a strong fiscal foundation. To that end, a multi-year strategy to achieve cost recovery while softening the impact on customers was approved. This included a fee package that will enable the partners to cover the increased costs of current service levels and match staffing to activity levels. Other than an adjustment to Fire's hourly rate, there were no development fee increases in 2005-2006. This Adopted Budget includes a 7% increase for Planning, Building and Public Works and 4.5% for the Fire Fee Program. This will cover rising costs in a number of areas: a 28% increase in retirement costs; a 16% increase in health care costs; the cost of modest, negotiated pay increases for staff; and cost component for office space in the new City Hall. The additional cost of new City Hall space is being phased in over five years for the development fee programs to mitigate the impact on the development community. City staff will continue to meet with development industry groups to ensure that their service delivery concerns remain a priority.

Several balancing strategies from prior years are reflected in this budget, including continued staffing reductions and redeployments that limit the Planning Services Division's ability to provide service within the Special Projects and SNI teams. Land use and planning actions to further the goals of the adopted SNI plans and specific plans will, however, be undertaken. Additional resources were approved to partner with existing staff and begin the comprehensive update of the General Plan within this fiscal year as well as move forward with annexing unincorporated islands within the City. Both projects are projected to take about three years to complete.

Environmental and Utility Services CSA

This CSA includes the San José/Santa Clara Water Pollution Control Plant, the Municipal Water System, South Bay Water Recycling, and Recycle Plus. Their primary value, lies in protecting the community's environmental resources, supporting its economic vitality, and providing essential public services such as garbage and recycling collection, wastewater collection and treatment, street

2006-2007 ADOPTED BUDGET MESSAGE

OPERATING BUDGET OVERVIEW (CONT'D.)

City Service Areas (Cont'd.)

Environmental and Utility Services CSA (Cont'd.)

sweeping, and storm water diversion. These large utilities also generate up to \$5 million annually in revenues for the General Fund through rate of return and in-lieu fees, plus approximately \$10 million annually in franchise fees from commercial solid waste activities and \$10 million in overhead payments.

Clean-up budget actions in 2005-2006 resulted in the transfer back to four originating wastewater funds of approximately \$18 million of excess money that had accumulated in two San José Payment Funds for San José/Santa Clara Clean Water Financing Authority Bonds. In order to take advantage of lower interest rates in 2005, the Financing Authority refinanced its 1995 series bonds for South Bay Water Recycling. During the refinancing, the excess reserves were identified. In the first Payment Fund, the accumulated \$4 million in revenue was used to pay off the bonds for which that Fund was established. Of the \$14.3 million excess revenue that accumulated in the second Payment Fund, \$12.5 million was transferred back to the Sewer Service and Use Charge Fund and enabled the City to reduce the magnitude of future projected increases in the sanitary sewer rate. The remainder is available for other uses as yet to be determined, including a portion that will be set aside in the source of funds until the issue of any potential rebate liability with the IRS can be reviewed with the City's arbitrage consultant. After researching the history of the Funds, it was concluded that the excess reserves accumulated for the following reasons: 1) budgeted payments for the variable rate bonds were appropriated at 5%, while actual payments were less due to lower interest rates during this time; 2) as the City's debt was amortized, the level of reserve funds required to be on deposit at the bank declined and the bank then applied these liquidated reserve funds to the debt service invoices, lowering actual payments; and 3) lack of a formal review of actual cash reserve levels and annual budgeted appropriations in the Payment Funds. Going forward, a number of administrative controls will be implemented to prevent the excess accumulation of revenue in the remaining Payment Fund.

While the economic downturn has had relatively limited impact on revenues for this CSA compared to those supported by the General Fund, stricter regulatory requirements and an aging infrastructure continue to affect the cost of delivering these programs. Highlights of the adjustments included in the Environmental & Utility Services CSA budget approved for 2006-2007 follow.

With the City's utility infrastructure continuing to age, the need to invest in rehabilitation is growing. To address the storm sewer system, the CSA has included a third year of funding (\$500,000) to replace or rehabilitate aging storm pump stations, reducing the risk of localized flooding in portions of the City and a second year of funding (\$500,000) to complement the City's Strong Neighborhood Initiative by allocating dollars for neighborhood storm drainage improvements to reduce localized ponding. To address critical unfunded needs in the sanitary sewer system, an allocation of \$300,000 for a pilot project to install a hydrogen peroxide injection station along Zanker Road to address odor

2006-2007 ADOPTED BUDGET MESSAGE

OPERATING BUDGET OVERVIEW (CONT'D.)

City Service Areas (Cont'd.)

Environmental and Utility Services CSA (Cont'd.)

issues and \$600,000 to remove grease and sediment from the City's large-diameter interceptor system have been approved.

Over the next 10 to 15 years, it is estimated that up to \$250 million will be required to fund infrastructure rehabilitation and repair projects at the wastewater treatment plant. Examples include \$64 million for electrical reliability improvements; \$15 million in valve, pump and motor replacements; \$10 million in underground piping replacement; \$30 million in old headworks rehabilitation; \$21 million in digester replacements and improvements; and \$10 million for replacement of 30-year old blowers. These investments are described in detail in the 2007-2011 Adopted Capital Improvement Program document. Additional funding strategies for addressing these needs will be brought forward during subsequent budget cycles.

The services of a consultant were approved to assist with a redesign of the Commercial Solid Waste Collection System in order to increase diversion from the landfill, enhance revenue collection capabilities, ensure a level playing field for competing haulers, and provide staff with administrative tools to address performance and service issues. This will also address Council's direction last March to develop a "Clean & Green Downtown" program using a City contractor to provide integrated garbage, recycling and cleaning services. Costs for this program were approved to be passed through to commercial customers in an exclusive downtown district as a means of improving service delivery and cleanliness in the downtown area. However, since this downtown program may not be fully implemented until 2009-2010, annual funding of \$500,000 through City and other agency contributions was approved to enable the departments of Transportation and Environmental Services to perform additional cleaning activities until the full downtown program is implemented.

An additional position was approved to be added to meet requests from schools for technical assistance to increase diversion of recyclable waste, as required by SB 373. This supports the City Council's endorsement last March of the "Go Green" Program, which promotes school-based environmental stewardship through recycling, composting, environmental education, environmentally preferred procurement, and evaluation of impacts of environmentally responsible behaviors. To implement existing federal NPDES (National Pollutant Discharge Elimination System) permit requirements for stormwater discharge, and avoid more burdensome regulations in the future, approximately \$400,000 was approved to provide a variety of activities and tools. Included will be operation and maintenance of treatment and storm flow control measures, installing devices to prevent trash from entering the storm sewer system and creeks, piloting Integrated Pest Management activities to minimize the use of pesticides, evaluating short- and long-term strategies for stormwater management, and providing additional staffing support to manage the stormwater programs.

Another addition will expand neighborhood parking enforcement on street sweeping days by posting signs on an additional 40 miles in targeted areas at a cost of \$240,000. This will be the

2006-2007 ADOPTED BUDGET MESSAGE

OPERATING BUDGET OVERVIEW (CONT'D.)

City Service Areas (Cont'd.)

Environmental and Utility Services CSA (Cont'd.)

fourth year of a multi-year strategy to keep neighborhood streets cleaner and prevent debris from polluting local creeks by enabling street sweepers to clean more thoroughly along curbs.

The City continues to address the requirements of the EPA Administrative Order (AO) issued in March 2005. Several additions are required to meet the mandates of the AO including: development and implementation of a training plan for Source Control, completion of an audit of the pretreatment and pollution prevention programs by an external auditor, and expansion of activities to monitor the sanitary sewer system. Additional resources were approved to implement a Fats, Oils, and Grease (FOG) inspection program and to expand the Pollution Prevention Programs as required by the Regional Water Board.

The above additions fund the highest priorities for the Environmental and Utility Services CSA and sustain and/or advance compliance with various regulations that this CSA must uphold. In addition, the CSA's regional partnering will be even more critical across core services in the coming fiscal years, particularly in continuing to address issues related to land development, water supply availability, and watershed protection.

Neighborhood Services CSA

The neighborhood focus of this CSA has been strengthened by last year's decisions to add the Housing Department and the Code Enforcement Division of Planning, Building and Code Enforcement. The Library Department and the Parks, Recreation and Neighborhood Services Department remain members of this CSA. As a reflection of these changes, the CSA has restated its mission as *"to serve, foster, and strengthen community by providing access to lifelong learning and opportunities to enjoy life, ensuring a diverse range of housing opportunities, and preserving healthy neighborhoods."*

As the second largest recipient of General Fund resources, the Neighborhood Services CSA has had to adjust to significant reductions over the past several years in order to generate savings and minimize impacts on other essential services. While some additional reductions were approved this year, this CSA will actually experience a net increase in resources primarily to meet the ongoing operating and maintenance needs associated with bond-funded facilities that will be opening in 2006-2007.

Within this CSA the 2006-2007 Adopted Operating Budget includes the addition of \$12.8 million and 58.27 positions across all funds. In the General Fund, a reserve fund earmarked for maintenance and operating costs of new facilities will be drawn down and \$3.5 million will be used to support 55 positions and other operating and maintenance costs associated with facilities opening in 2006-2007. This includes new and replaced branch libraries, new community centers, trail segments, parks (both new and expanded), as well as dog parks. For the first time in a number of

2006-2007 ADOPTED BUDGET MESSAGE

OPERATING BUDGET OVERVIEW (CONT'D.)

City Service Areas (Cont'd.)

Neighborhood Services CSA (Cont'd.)

years, the CSA will not have to stretch existing resources thinner in order to operate and maintain the new facilities or acreage. Resources were approved to be added to allow the Library and PRNS to operate their new sites and facilities at the current levels of service.

The Library Department will offer fundamental and essential library services at much the same level as in 2005-2006. Although 4.6 vacant positions were approved for elimination, there are no changes to the current library hours. The previously mentioned reserve funds will provide operating and maintenance services for four new and expanded branch libraries that will be fully operational (Almaden, Evergreen, Cambrian, and Hillview) in 2006-2007.

A slight change in the scheduled grand opening of two new branches will allow for nominal staff and resource savings to be realized in the General Fund for 2006-2007. Nearly all 20 projects funded from the 2000 Library Bond will be in design, under construction, or completed in 2006-2007. The 2006-2007 Adopted Operating Budget also provides ongoing funding for administrative support for the Smart Start and Early Care programs with the approved reallocation of existing resources for essential administrative support. In addition, a Literacy Program Specialist position was also added in the Early Care and Lifelong Unit. This previously grant-funded position will continue to provide support to the Family Learning Center and assist in implementing literacy initiatives.

Parks, Recreation and Neighborhood Services (PRNS) Department previously presented to the City Council in May 2005 a "Facility Re-Use Strategy". The original strategy proposed an evaluation of the feasibility of alternative operations for 32 select neighborhood and satellite facilities. The Facility Re-Use Strategy is intended to leverage the bond measure approved by voters in 2000 by consolidating City operations into larger more efficient facilities (Multi-Service Delivery System) and reduce the City's ongoing operational expenses by identifying alternative providers qualified and interested in assuming operational responsibility of select neighborhood and satellite community center facilities. Per Council action at a December 13, 2005 City Council meeting, a separate re-use process was established for the Northside Community Center. On June 6, 2006 the Department presented to the City Council, a "Follow-Up to Facility Re-Use Request for Qualifications (RFQ) Process" report. The City Council adopted various funding actions to continue operations at 22 community centers, neighborhood centers, and youth centers for an additional year, and directed staff to 1) conduct additional neighborhood specific outreach meetings; 2) explore the feasibility of revising the Healthy Neighborhoods Venture Fund (HNVF) and other major grant programs to follow a San José BEST model or other best practices, beginning in July 2008 for the 2008-2009 cycle, to include reuse; 3) to include BEST or any other best practices that staff deems appropriate; and 4) recruit child care providers that want to be considered for reusing community centers as Smart Start centers if no service providers are available to continue other programs.

2006-2007 ADOPTED BUDGET MESSAGE

OPERATING BUDGET OVERVIEW (CONT'D.)

City Service Areas (Cont'd.)

Neighborhood Services CSA (Cont'd.)

In park maintenance, the maintenance capabilities for our parks will not be negatively impacted except for a change in the way maintenance activities are conducted at the San José History Park. As noted above, assets have been added to address maintenance and operations at new and improved park sites, but are only sufficient to maintain current service levels. Beginning in 2005-2006, the neighborhood park maintenance schedule was reduced by two days, while regional park maintenance dropped to six days per week. Two positions that manage the delivery of small capital projects in-house and are supported by the General Fund were approved to be transferred to Capital Fund support. Team San José will be assuming responsibility for Convention Center grounds maintenance and the 1.5 City staff positions was eliminated.

Therapeutic Services, the Office on Aging and the Aquatics Program are not reduced in this budget and current service levels will be maintained. The Future Teacher Loan Program was approved to be eliminated since interest in the loans has waned and the action realizes a \$100,000 savings annually without any significant impact. Other areas approved for reduction include reduction of staffing in the Adult Sports Program, which will increase the cost-recovery level from 83% to 98%. Several fee increases in PRNS will generate \$56,000 in additional General Fund revenue.

The Strong Neighborhoods Initiative (SNI) is the core of the City's efforts to ascertain neighborhood priorities, deliver effective neighborhood services, and develop effective community leadership and partnerships with residents. Since its inception through this fiscal year, 104 top ten priority capital projects have been completed and 48 more are underway. In response to the Mayor's Budget direction to expand the Strong Neighborhoods program to other areas of the City, \$5 million in one-time General Fund dollars was reserved, of which \$725,000 was allocated to establish a Building Strong Neighborhoods Pilot Program. In the coming fiscal year, staff will be working on an implementation plan to extend the SNI model of community building and service delivery in three pilot areas.

At the City Council's direction, the Neighborhood Development Center (NDC) was transferred from PRNS to the Strong Neighborhoods Team under the direction of the City Manager's Office. The NDC will be integral to the successful evolution of the Strong Neighborhoods Program into the Building Strong Neighborhoods Pilot Program as NDC staff already operate at a city-wide level and have helped establish organizations across San José.

By formally aligning the NDC and Building Strong Neighborhoods pilot efforts with the Strong Neighborhoods team, staff intends to build and sustain capable, cohesive, and action-oriented organizations that can effectively partner with City departments to implement neighborhood priorities and improve service delivery.

2006-2007 ADOPTED BUDGET MESSAGE

OPERATING BUDGET OVERVIEW (CONT'D.)

City Service Areas (Cont'd.)

Neighborhood Services CSA (Cont'd.)

In the Adopted Budget, Code Enforcement will continue its commitment to respond to complaints that involve immediate threats to life and safety within 24-48 hours. In addition, in an effort to improve responsiveness to minor blight conditions – which negatively impact the “quality of life” in our neighborhoods – Code Enforcement has implemented an enhanced inspection program that will improve response times significantly. The addition of two fee-supported positions was approved – one will be dedicated to the Multiple Housing Program, the other will renew the Abandoned Shopping Cart Enforcement Program.

To better coordinate the administration of federal Housing and Community Development funds, the Community Development Block Grant Program, which has been part of PRNS, will be consolidated with other HUD programs in the Housing Department and overall staffing for CDBG administration will increase by one position under actions included in this budget. A Development Specialist position has also been added to support the growing loan portfolio compliance and servicing requirements. In this period of reduced funding for affordable housing, a focus on non-monetary activities will continue, including identifying new sites for housing development, strengthening the City’s inclusionary housing program, implementing a new secondary unit pilot program, addressing concerns regarding illegal secondary units, revising Single-Room Occupancy requirements, lobbying for continued federal funding, supporting City Rent Control programs, and promoting fair and equitable lending.

Safe schools remain a high priority for the Neighborhood Services CSA and this Adopted Budget sustains existing service levels for the Safe Schools Campus Initiative response teams and the operational services of our Youth Intervention Services (YIS) Programs. However, 3.26 positions (vacant for more than a year) in the anti-gang Striving Toward Achievement with New Direction (STAND) are eliminated in order to create two positions to consolidate management and oversight of all of the YIS Programs. These additions will increase the efficiency, effectiveness and consistency of these programs and result in more complementary and coordinated services.

Though these are difficult economic times, the Neighborhood Services CSA continues creatively to rethink City service delivery, build on and create new partnerships, and connect with residents and stakeholders to identify neighborhood priorities.

Public Safety CSA

Services in the Public Safety CSA remain among the City’s highest priorities. In 2005-2006, the Public Safety CSA refocused on its “roots” to maintain essential services that enhance safety in our neighborhoods during day-to-day events, natural disasters, or terrorist threats. The safety of our residents and businesses remain our first priority. For 2006-2007, resources will continue to be focused on providing these essential emergency services in a timely manner and to ensure fast

2006-2007 ADOPTED BUDGET MESSAGE

OPERATING BUDGET OVERVIEW (CONT'D.)

City Service Areas (Cont'd.)

Public Safety CSA (Cont'd.)

response times and to invest in effective prevention efforts so San José residents both are safe and feel safe in their neighborhoods.

Included in the 2006-2007 budget are the restoration of a permanent dedicated Hazardous Incident Team, previously funded on a one-time basis; and additional resources for new Fire Stations #33 and #35, slated to open in July 2007. A total of 35 positions will be added or restored to ensure adequate fire response in the Communications Hill area and South San José and to maintain the current level of dedicated hazardous materials response. In order to enhance downtown and school safety, ten new Police Officer positions were approved.

The recent transfer of wireless 9-1-1 calls from the Highway Patrol to local agencies has increased the number of calls handled by City staff and consequently the average answering times for 9-1-1 calls. The addition of six Public Safety Dispatcher positions will decrease the average answering time for 9-1-1 calls to levels experienced prior to the transfer of these calls (2004-2005 actual average was 3.97 seconds). The continuation of the Emergency Communication System Support Fee will allow the funding of these positions and should improve the dispatch service in the City. Police Department Operations Support Services Division has experienced significant backlogs entering and providing reports for the public and officers. A two-year task group will provide six additional Police Data Specialist positions in order to address this issue. Combined with the filling of current vacancies, this group is expected to reduce the backlogs experienced to more acceptable levels. Having reports available and up-to-date will help to ensure the safety of officers and improve customer service delivery.

Continuing with the focus of maintaining vital public safety services and consistent with the Mayor's March Budget Message, one Senior Analyst position was added to expand "San José Prepared!" to new neighborhoods citywide. New abbreviated four-hour training courses, an update to the Office of Emergency Services website, and new strategies to optimize the effectiveness of existing training courses will be achieved as a result. The addition of a Police Website Coordinator will improve information delivery and customer service to the general public including crime prevention presentations and updated crime statistics. The addition of one Hazardous Materials Inspector, funded by Fire Fees, will ensure timely inspections of underground storage tanks and complex hazardous materials facilities required as part of new State-mandated regulations. Several resource reductions were approved to generate savings in the General Fund while maintaining this CSA's focus on vital emergency services delivery. In total, the elimination of 7.38 vacant positions in the Police Department generated \$478,000 in General Fund savings. Reduced support for the Court Liaison Unit and increased supervisory responsibility for remaining School Safety Coordinators, as currently realized by these vacancies, will occur on a permanent basis. Lastly, the elimination of one Fire Engineer Academy and the shifting of Fire Apparatus Replacement funding to the Capital Fund generated \$1 million of General Fund savings with no service impact in 2006-2007.

2006-2007 ADOPTED BUDGET MESSAGE

OPERATING BUDGET OVERVIEW (CONT'D.)

City Service Areas (Cont'd.)

Public Safety CSA (Cont'd.)

While the above actions may include some minimal impact on services, it should be noted that with its 2006-2007 approved funding level, the Public Safety CSA will:

- Continue to provide essential emergency services in a timely and effective fashion;
- Continue to meet EMS paramedic contractual requirements;
- Maintain investigation concentration on crimes against persons;
- Maintain school liaison functions and protocols including SHARP and Safe Schools Initiative;
- Continue to protect the health and safety of Public Safety personnel;
- Move forward with Bond projects that do not adversely affect operating expenditures;
- Continue to explore opportunities for public outreach and training to make residents more capable of maintaining their individual safety;
- Effectively investigate arson fires and aggressively pursue, apprehend, and prosecute suspects in these incidents;
- Continue to use grant funding to pursue inter-agency communications projects, in compliance with Department of Homeland Security directives; and
- Continue to put San José in the forefront of Homeland Defense in Northern California by continued active participation in the FBI's Terrorist Task Force and strong linkage with Homeland Defense

In addition to the above augmentations, in 2006-2007 we will report back to Council with a complete five-year staffing plan that provides a clear picture of our public safety needs and reflects projections of retirements, community growth and demographic trends, efficiencies from alternative service delivery models and other factors.

Transportation and Aviation CSA

The upcoming fiscal year marks the second for the Transportation and Aviation Services CSA which now has a consolidated service mission – to provide the community with safe, secure, and efficient surface and air transportation systems that support San José's livability and economic vitality.

The CSA partners have undertaken several major coordinated initiatives, such as reconstruction of the Coleman Avenue/Interstate 880 interchange, reconstruction and landscape redesign, and implementation of a new taxi service model at Norman Y. Mineta San José International Airport. Over the upcoming year, additional efforts will be undertaken in the following areas:

- Pursuing long-range regional transit connections;
- Implementing parking management and revenue control systems;

2006-2007 ADOPTED BUDGET MESSAGE

OPERATING BUDGET OVERVIEW (CONT'D.)

City Service Areas (Cont'd.)

Transportation and Aviation CSA (Cont'd.)

- Identifying additional in-sourcing opportunities;
- Continuing neighborhood livability strategies to mitigate transportation system impacts; and
- Enhancing communication infrastructure linkages between the Airport and the City's Emergency Operations Center.

The CSA is undertaking this continuous effort to improve service delivery despite the resource limitations necessitated by our region's prolonged economic downturn. Over the past few years, both surface and air transportation systems have suffered severe reductions in revenues needed for capital development and operations and maintenance. The upcoming year reflects continued strain on transportation revenues. Nonetheless, in keeping with City Council direction, this budget avoids drastic cuts in transportation operations and maintenance.

Though new reductions are not as significant for the surface transportation system as in years past, the condition of the City's system is in decline, and current funding is insufficient to adequately maintain, operate, and improve it. An estimated \$370 million would be needed for one-time transportation infrastructure rehabilitation and capital improvements, and an ongoing annual operating and maintenance shortfall is projected between \$18 and \$24 million over the next 5 years. In recognition of this disparity between needs and resources, one-time funding for street resurfacing, traffic safety enhancements and improved neighborhood appearance in the amount of \$5.3 million was approved in the General Fund in 2006-2007. As noted earlier in this message, these funds will begin to address the backlog in transportation infrastructure maintenance. In addition, the sidewalk repair grant program will remain at the same level of funding which, based on historical use, should carry the program through eight months. Over the past five years, the City has spent approximately \$9 million on sidewalk repairs.

For the air transportation system, this Adopted Budget reflects the City's commitment to support a scaled-back yet accelerated Airport Master Plan projected for completion in 2017. The most significant component of this \$1.5 billion plan is the Terminal Area Improvement Program, which includes improvements to Terminal A, construction of Terminal B, demolition of Terminal C, and various roadway projects and associated utility improvements. To support the revised capital program and ensure the new terminal, roadway, and parking facilities are designed and constructed for a positive, reliable, and efficient traveler experience, the Airport will add several new positions, including two temporary Terminal Area Development Managers, a Sign Shop Manager, a Governmental and Legislative Affairs Manager, and the Air Service Development Manager through the elimination of 10 vacancies. This approved staffing realignment will enable the Airport to restructure terminal area management duties, respond quickly to construction signage requirements, liaison with lobbyists and government staff and procure government funding, and assist with air service development.

2006-2007 ADOPTED BUDGET MESSAGE

OPERATING BUDGET OVERVIEW (CONT'D.)

City Service Areas (Cont'd.)

Strategic Support CSA

The Strategic Support CSA is made up of Human Resources, Retirement, Finance, Information Technology, General Services and Public Works. The CSA's outcomes are:

- A high performing workforce that is committed to exceeding internal and external customer expectations;
- Safe and functional public infrastructure, facilities, and equipment;
- Effective use of state-of-the art technology; and
- Sound fiscal management that facilitates meeting the needs of the community.

In the fifth consecutive year of reductions, the CSA is working diligently to prioritize and provide the most critical services in a quality manner. Though approved reductions are less severe than in recent years, a number of staff positions are, nevertheless, approved for elimination, making it increasingly difficult to provide core services at the desired level. For example, IT staff reductions have made it difficult to provide basic services to departments, while simultaneously managing new IT systems being brought on-line. Another reduction will reduce one-time vehicle replacement funding. General fleet replacements have now been frozen for five years, and the average age of the fleet, which includes vehicles from sedans to heavy equipment, is ten years. The vehicle replacement fund will be reduced by \$1.0 million leaving only \$750,000 to address any purchasing needs during the coming fiscal year.

Concurrent with these and other ongoing reductions, the CSA is, however, approved to receive several key additions to the budget to address Council priorities and achieve the outcomes stated above.

During the next five years, the City's existing workforce may be reduced by as much as one-third due to retirements. This presents both a challenge and an opportunity for "building the bench" and to make further progress in diversifying the workforce, especially in the executive and senior management positions. In anticipation of this, one-time resources were approved for consulting services (\$100,000), and an additional staff person (\$102,835 ongoing) will be devoted to managing this effort. A plan to address these concerns is under development and over the next fiscal year we will begin to implement specific initiatives.

The Departments of General Services and Public Works are charged with providing a safe and functional public infrastructure, which now includes City Hall. In addition to delivering quality capital projects such as City Hall, this responsibility includes managing operational and custodial services. As City Hall is newer, larger and more complex than any other City facility, it carries with it the expectations for a higher quality of maintenance. General Services was provided with additional funding for contract custodial services when the building opened, and an addition was approved in

2006-2007 ADOPTED BUDGET MESSAGE

OPERATING BUDGET OVERVIEW (CONT'D.)

City Service Areas (Cont'd.)

Strategic Support CSA

this budget to bring daytime custodial services in-house by adding two positions and redeploying a third. In addition, through careful analysis, the CSA identified opportunities to in-source electrical and fleet maintenance activities at substantial savings.

Consistent with the City's desire to effectively use state-of-the-art technology to improve customer service and create operational efficiencies, a one-time \$3.5 million reserve was approved in this budget to address the most critical technology needs for the City. A listing of recommended projects to be funded is still under review, but it is clear that the amount of money in the reserve will not be sufficient to meet all of the current identified needs in this area. Specific proposals for the use of this reserve will be brought forward to the City Council for consideration at a later date.

Several other technology-related changes also were approved that will improve access to data and streamline work processes. The City will be installing WiFi connectivity in the downtown zone and funding will support maintenance costs for this new system (\$48,000). For Public Works, funding was approved (\$155,000) to design and to begin to develop a City-owned property database to enable review of property history and site characteristics prior to engaging in development plans. Secondly, funding was included (\$50,000) to improve the Public Works Inter- and Intranet sites to enable users to look up services and search for documents without staff assistance.

Information Technology is responsible for managing the Voice Over Internet Protocol (VoIP) system installed in the New City Hall. The CSA received funds (\$610,000) to continue Nortel's managed services for an additional year while IT staff complete the required training to fully take over maintenance and operation of the system from Nortel.

The CSA has been working for several years, along with the Environmental and Utility Services CSA, to develop a new Consolidated Utility Billing System (C-UBS). C-UBS, which went "live" at the beginning of July, is a comprehensive system that will for the first-time provide a one stop customer service and consolidated utility billing interface. Legacy municipal water, RecyclePlus, and storm and sanitary sewer billing systems were replaced. There is now a consolidated utility bill for storm and sanitary sewer billing systems. There is also a consolidated utility bill for RecyclePlus and Municipal Water customers, Internet self service, a direct interface to hauler field activity systems, and management portals with enhanced reporting for partner performance monitoring. In addition, the program consolidates the City's Utility and Customer Service call centers. Because Information Technology, Finance, and Environmental Services Departments will be involved in stabilization efforts following the launch, the CSA received additional funding for staff dedicated to this effort during the first quarter of 2006-2007, and the addition of one permanent Information Technology staff member to ensure full-scale operation of the new system.

2006-2007 ADOPTED BUDGET MESSAGE

OPERATING BUDGET OVERVIEW (CONT'D.)

City Service Areas (Cont'd.)

Strategic Support CSA

Three other augmentations will strengthen the City's fiscal management. Funding was approved (\$344,000) to initiate a phased plan to centralize the procurement process and enable Purchasing to provide oversight and assistance with the addition of two Senior Analyst positions. This will ensure efficient, consistent, fair, and transparent RFP/RFQ processes for procuring professional services. In the Finance Department's Investment Section, the addition of a Financial Analyst was approved to strengthen oversight of the City's \$2 billion investment portfolio. Finally, an internal Grants Management Team will be formed using existing resources and led by a City Manager's staff person with an additional staff person from Housing and from PRNS. In response to audit recommendations and the Mayor's Message, this team will strengthen oversight of grants provided by the City.

Finally, in order to recover fees paid to collection agencies the City will levy a \$25 or 15% fee, whichever is higher, on delinquent accounts in the General Fund. This will generate at least \$200,000 annually.

CAPITAL BUDGET OVERVIEW

The capital investments planned over the next five years are substantial with a 2006-2007 Adopted Capital Budget of \$1.38 billion and a 2007-2011 Adopted CIP of \$2.89 billion. This marks the sixth year that the annual budget exceeds \$1 billion and the five-year plan is in the multi-billion dollar range. The 2006-2007 Adopted Capital Budget also reflects an increase of 18% from the 2005-2006 Adopted Capital Budget of \$1.17 billion and the 2007-2011 CIP is 37% higher than the 2006-2010 Adopted CIP of \$2.10 billion. The increases from last year are primarily the result of revisions to the timing of Airport improvements.

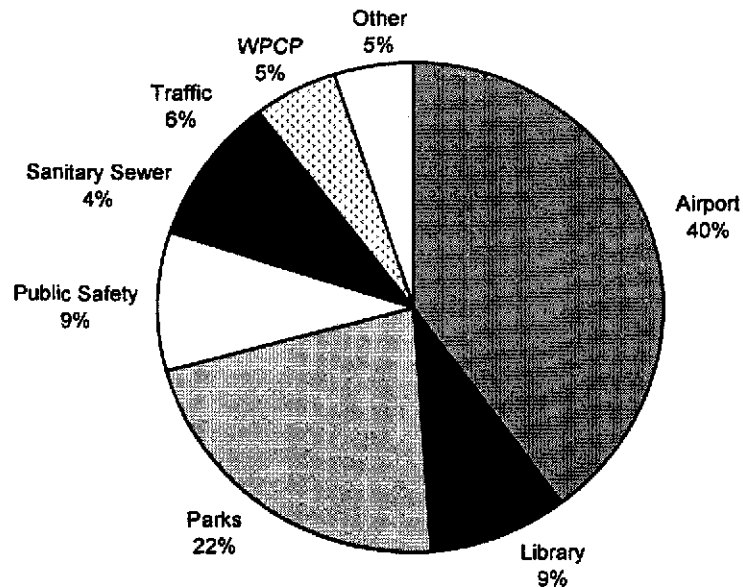
The City is now in the second half of the *Decade of Investment*, which is transforming much of the City's infrastructure. Major improvements continue in the City's parks, community centers, libraries and public safety facilities, primarily as a result of voter-approved bond measures that will generate a total of \$599 million for these purposes. The expansion of the Airport will deliver a facility that meets the needs of both customers and the airlines in a cost effective manner. Substantial investments in the City's utility infrastructure are also underway, designed to ensure the continued safe and efficient operation of these facilities and the capacity to address future growth.

2006-2007 ADOPTED BUDGET MESSAGE

CAPITAL BUDGET OVERVIEW (CONT'D.)

The CIP is comprised of 15 capital programs. Following is a breakdown of the major programs:

2006-2007 Adopted Capital Budget



Unmet Infrastructure Needs

Over the past six years, the City has been able to address a number of significant infrastructure needs throughout the City. However, there are other major infrastructure categories where the available funding for capital improvements is insufficient to address critical needs. With much of the City's infrastructure built in the 1960s and 1970s, the number of aging City facilities that require significant renovations or replacement is considerable.

The transportation system has the largest backlog of unfunded capital improvement needs. The available funding over the next five years falls well below even the minimum level necessary to address the City's basic transportation infrastructure needs. With this large disparity, the administration will continue to actively seek federal and State funds to augment the local funding available. To begin to address the most critical transportation infrastructure maintenance needs, the 2006-2007 Adopted Budget includes one-time funding of \$5.3 million from the General Fund for street resurfacing, traffic safety enhancements, and neighborhood appearance improvements. The Adopted Traffic CIP also includes \$200,000 for a Transportation Needs Master Plan to provide an updated study of transportation infrastructure conditions, needs, funding options and community priorities.

2006-2007 ADOPTED BUDGET MESSAGE

CAPITAL BUDGET OVERVIEW (CONT'D.)

Unmet Infrastructure Needs (Cont'd.)

Municipal facilities and convention and cultural facilities also have a significant backlog of infrastructure needs. For instance, there is almost \$9 million in deferred maintenance for City buildings (police, fire, community centers, industrial shops, and offices) and approximately \$8 million in capital improvements that have been identified for the City's various cultural facilities. With the persistent funding shortfalls in the recent years, the General Fund investment in these facilities has been negligible given the competing demands for these resources. In the 2006-2007 Adopted Budget, a \$1 million one-time allocation was approved to start addressing the backlog of deferred facility maintenance at municipal facilities. These funds will be allocated to those facilities that do not have another available funding source for improvements.

For those facilities that have seen improvements in recent years as a result of one-time funds, most notably the parks, library, and public safety facilities, a sustainable capital replacement system needs to be developed to ensure that the new and remodeled facilities can be maintained over time. In the Parks Capital Program, for example, a portion of the Construction and Conveyance Tax Funds in each district and City-wide is allocated annually to meet capital replacement needs. To the extent possible, the administration will be pursuing the development of capital replacement strategies for other categories of City facilities as well.

The systems that are supported by user fees, such as the water pollution control plant, the municipal water system, and the sanitary and storm sewer systems also have varying sizes of capital infrastructure backlogs that cannot be fully addressed with the current fees. Therefore, it is anticipated that rate increases in a number of categories (e.g. storm, sewer, and municipal water) will be necessary to fund the major improvements that will be necessary in upcoming years.

General Fund Operating Budget Impact

As has been repeatedly noted, the large number of new and expanded facilities continuing to come on-line bring with them a substantial price tag in terms of General Fund operating and maintenance costs. The 2006-2007 Adopted Operating Budget includes over \$3 million to operate new parks and library facilities that are scheduled to be operational next year. In addition, funding is included to start training fire personnel that will be necessary to staff two new stations that are coming on-line in 2007-2008. This level of investment is expected to increase significantly over the next five years as the remaining bond-funded parks, library, and public safety facilities come on-line.

As detailed below, General Fund operating costs for facilities included in the 2007-2011 CIP will total \$7.5 million in 2007-2008 and climb to \$26.7 million by 2010-2011. (Operating budget adjustments for facilities scheduled to come on-line in 2006-2007 have been incorporated into the Adopted Operating Budget.)

2006-2007 ADOPTED BUDGET MESSAGE

CAPITAL BUDGET OVERVIEW (CONT'D.)

General Fund Operating Budget Impact (Cont'd.)

Projected General Fund Operating and Maintenance Costs

Project Title	2007-2008	2008-2009	2009-2010	2010-2011
Fire Facilities	\$ 4,545,000	\$ 7,195,000	\$ 7,550,000	\$ 10,563,000
Library Facilities	2,825,000	4,514,000	8,428,000	10,256,000
Parks Facilities	273,000	2,623,000	4,529,000	4,896,000
Parks Facilities-Other Agencies	27,000	58,000	124,000	153,000
Police Facilities	26,000	376,000	753,000	789,000
Traffic Projects	(220,600)	(153,600)	(123,600)	(110,500)
Traffic Projects-Other Agencies	99,000	104,000	110,000	115,000
Total	\$ 7,574,400	\$ 14,716,400	\$ 21,370,400	\$ 26,661,500

In the last few years, several strategies were implemented to minimize operating and maintenance costs. These efforts included deferring the completion date for capital projects, using alternative staffing models, moderate reductions in the size of facilities, the development of joint library and community center facilities, and the implementation of capital projects that would reduce costs, such as energy efficient traffic signals.

Given the extent of the actions that have already been taken and the competing trend of rising construction costs, the Adopted CIP did not include significant additional project deferrals. Our program focus is to deliver on the commitments to the public in regards to completing the park, library and public safety projects that were approved by the voters and are being funded by General Obligation Bonds. The additional costs associated with these facilities are therefore being factored into the General Fund Five-Year Forecast. The City will continue to analyze the overall complement of facilities and resources available to the public when determining future potential budget actions that may be necessary to balance the General Fund budget. As has been the case with the parks facilities, this may necessitate closing older City facilities as new facilities are opened. Staff will also continue to pursue measures designed to reduce the operating and maintenance costs for the City.

Capital Program Overview by City Service Area

As a framework for its performance-based budget, each of the 15 capital programs has been aligned to one of the six CSAs. Following is a brief discussion of significant issues and projects included in the Adopted CIP is presented by CSA.

2006-2007 ADOPTED BUDGET MESSAGE

CAPITAL BUDGET OVERVIEW (CONT'D.)

Capital Program Overview by City Service Area (Cont'd.)

Community and Economic Development CSA

The Community and Economic Development CSA includes the Developer Assisted Projects Capital Program. This program reimburses residential developers for construction of major City streets and encourages the undergrounding of existing overhead utilities. Reimbursements to developers are scheduled for the Communications Hill and the Dairy Hill projects. In the Underground Utility Program, projects in the following areas are programmed in the CIP: Saratoga Avenue – Route 280 to Kiely; Jackson/Taylor – 4th to 9th Streets; Stevens Creek – Calvert to Stern; Camden Avenue – Bascom to Leigh; Evergreen Park – San Felipe Road to Yerba Buena; and Guadalupe Gardens (bounded by Coleman Ave, Route 880, and Guadalupe River).

Environmental and Utility Services CSA

The Environmental and Utility Services CSA includes the Sanitary Sewer System, Storm Sewer System, Water Pollution Control, and Water Utility Capital Programs.

Sanitary Sewer System Capital Program: The objectives of this capital program are to rehabilitate large diameter sanitary sewers; reduce water inflow and infiltration in sanitary sewers; improve local neighborhood sewers; extend sanitary sewers to new development areas; and develop a city-wide sanitary sewer master plan. Major projects in the Adopted CIP include the Phases VA and VB of the Edenvale Sanitary Sewer, Phases VI and VII of the Fourth Interceptor; Phases VIB, VII, and VIIA of the 84-Inch RCP Interceptor; and the Central Interceptor Sewer. In addition, several neighborhood sewer improvement projects are programmed, including Almaden Road, Alum Rock Avenue, Julian-Sunol Area, Monterey-Riverside, and Union/Almaden Oak.

Storm Sewer System Capital Improvement Program: The purpose of the storm sewer system is to collect storm water and convey it to nearby creeks and rivers. In conjunction with the Sanitary Sewer System Capital Improvement Program, the Storm Sewer System CIP will remove cross-connections between the two systems.



Willow Street Storm Pump Station Project

In accordance with the City's General Plan, the goal of the Storm Sewer System CIP is to reduce the risk of drainage-related surface damage and protect the quality of storm water runoff. Rate increases of 4.5% annually are assumed in each of the five years of the CIP. This would build in predictable, measured adjustments in service charges to continue a modest investment in the capital infrastructure and ensure

the fiscal health of the Storm Sewer Operating and Capital Funds. With the limited resources currently available, the major storm drainage improvement projects programmed in the Adopted

2006-2007 ADOPTED BUDGET MESSAGE

CAPITAL BUDGET OVERVIEW (CONT'D.)

Capital Program Overview by City Service Area (Cont'd.)

Environmental and Utility Services CSA (Cont'd.)

CIP are as follows: Albany-Kiely Storm Drainage Improvement, Phases III and IV; Chateau Drive Storm Drain Improvement, Phases I and II; Outfall Rehabilitation; Ross – Guadalupe Storm Drain Improvements; Storm Drainage Improvements – Special Corridors; Storm Pump Station Rehabilitation and Replacements; and Willow Glen-Guadalupe, Phase III.

Water Pollution Control Capital Program: The San José/Santa Clara Water Pollution Control Plant (WPCP) is a regional wastewater treatment facility serving eight tributary sewage collection agencies, including municipalities and sanitary sewer districts. This CIP focuses on preserving the WPCP infrastructure and capacity improvement projects. In order to maintain the program represented in this document, this CIP assumes rate increases will also continue annually beyond the three-year 4.5% rate increase that was approved by Council in 2004 for the Sewer Service and Use Charge Fee. At least this level of annual increase will be necessary to fund major capacity improvement projects and critical projects at the Plant.

The Adopted CIP includes funding to complete the \$89 million Water Pollution Control Plant Reliability Improvements project, which was awarded in 2005 and is scheduled to be completed in 2008. This project will improve the Plant's ability to handle wet weather flows, improve the reliability of several of the Plant's critical systems; and look at ways to improve the reliability and efficiency of producing recycled water, as well as water discharge to the bay. The Plant Electrical Reliability project has \$55.0 million programmed in the CIP for major upgrades and replacements of electrical systems.

Water Utility System Capital Program: The San José Municipal Water System provides water utility service to approximately 26,500 customers (approximately 104,000 residents) in five areas within the City of San José: Evergreen, North San José, Alviso, Edenvale, and Coyote Valley. Major projects in the Adopted CIP include: rehabilitation and replacement projects (Forestwood Drive Main Replacement, Water Valve Rehabilitation, Villa Vista Reservoir Rehabilitation, Reservoir System Seismic Retrofit, and Norwood Pump Station Replacement); System Development projects designed to provide more capacity or better coverage (Nortech Parkway East Loop Main, the North First Street Parallel Main, and the Montague Turnout); and recurring projects to maintain the system and address system growth (System Maintenance/Repairs, Infrastructure Improvements, Meter Installations and Service Installations).

2006-2007 ADOPTED BUDGET MESSAGE

CAPITAL BUDGET OVERVIEW (CONT'D.)

Capital Program Overview by City Service Area (Cont'd.)

Neighborhood Services CSA



Rose Garden Branch Library

The Neighborhood Services CSA includes the Library and Parks and Community Facilities Development Capital Program.

Library Capital Program: The City's library system is undergoing a major transformation as a result of the November 2000 voter-approved bond measure that approved the issuance of \$212 million in General Obligation bonds to improve the branch library system over a ten year

1 funding for the reconstruction or replacement of 14 of the 17 existing branches and the construction of six new branches in unserved neighborhoods. Over the course of the 2007-2011 CIP, the build-out will be completed with the opening of three new branches and completion of ten expansion/relocation projects. In the 2007-2011 CIP, upward adjustments of \$17.0 million to the budgets for the Library Bond projects were approved to address recent cost escalation. These increases will be mitigated through allocations of interest from bond sales and the use of the Bond Contingency Reserve. Listed below are the new and renovated branches that will be completed over this five-year period.

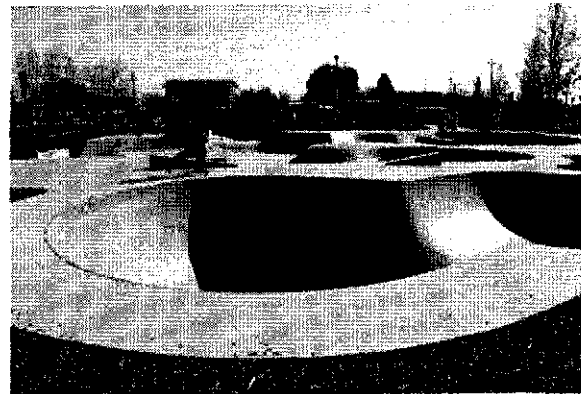
New Branches

- | | | |
|----------|------------|-------------|
| - Bascom | - Edenvale | - Southeast |
|----------|------------|-------------|

Renovated Branches

- | | | |
|-----------------|-------------------|----------------|
| - Cambrian | - Hillview | - Santa Teresa |
| - Calabazas | - Joyce Ellington | - Severtrees |
| - East San José | - Pearl | - Willow Glen |
| - Educational | | |

Parks and Community Facilities Capital Program: The Parks and Community Facilities Capital Program plans for and implements the acquisition, development, and protection of parks, recreation facilities, and open space to maintain a high quality of life in San José. The program is managed through the use of 17 funds, including 10 Council District funds, a City-wide fund for city-wide/regional facilities, a Parks Bond Fund, and five special purpose funds, as well as contributions from the General Fund and the San José Redevelopment Agency.



Plata Arroyo Skatepark

2006-2007 ADOPTED BUDGET MESSAGE

CAPITAL BUDGET OVERVIEW (CONT'D.)

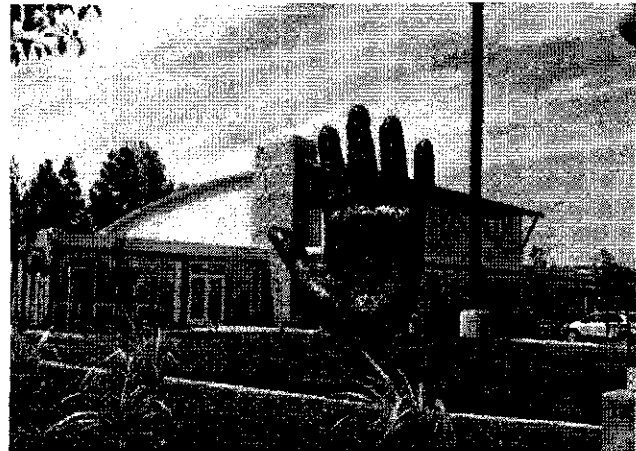
Capital Program Overview by City Service Area (Cont'd.)

Neighborhood Services CSA (Cont'd.)

The Parks and Recreation Bond Projects Fund provides a significant amount of resources to address capital needs in the City's various park facilities. On November 7, 2000, City voters approved Measure P, a \$228 million General Obligation Bond for park and recreational facilities improvements. This bond program provides funding to renovate 69 neighborhood parks, renovate six community centers, add 3 new community centers, build new sports complexes, expand the City's trail system at four locations, and enhance four regional park facilities, including a major renovation of Happy Hollow Park and Zoo. The 2007-2011 Adopted CIP includes \$137.9 million for the construction of Bond projects. Over the course of this CIP, four community centers will be renovated or built, sports fields will be developed, Happy Hollow Park and Zoo will be renovated, and several City trails will be expanded. Similar to the Library Capital Program, the 2007-2011 CIP includes upward adjustments of \$15.5 million to the budgets for the Parks Bond projects to address recent cost escalation. These increases will be mitigated through scope management, allocations of interest from bond sales, and the use of the Bond Contingency Reserve. In addition, supplemental funding of \$18.3 million from Construction and Conveyance Tax Funds, the Park Trust Fund, and the Redevelopment Agency will be used to complete the community center projects and the Happy Hollow Park and Zoo renovation.

Listed below are the Parks Bond Projects in the 2007-2011 CIP:

- Bascom Community Center
- Coyote Creek Trail
(Phelan Avenue to Idlewood Court)
- Emma Prusch Memorial Park
- Guadalupe River Trail Reach VI
(Woz Way to Willow Street)
- Happy Hollow Park & Zoo
- Los Gatos Creek Trail Reach IV
- Mayfair Community Center
- Roosevelt Community Center
- Soccer Complex
- Softball Complex
- Solari Community Center



Camden Community Center

The Parks, Recreation and Neighborhood Services Department, with the assistance of the Finance Department, completed a thorough reconciliation of the Park Trust Fund. The 2007-2011 CIP incorporates that reconciliation and includes funding of \$70.0 million, which has been allocated to various projects and reserves.

2006-2007 ADOPTED BUDGET MESSAGE

CAPITAL BUDGET OVERVIEW (CONT'D.)

Capital Program Overview by City Service Area (Cont'd.)

Public Safety CSA

The objective of the Public Safety Capital Program is to provide, maintain and improve facilities and equipment that support the delivery of effective emergency services to residents and visitors. The construction of a new police substation, a new public safety driver training center, four new fire stations including a developer-funded station, a renovated 9-1-1 communications dispatch center, the relocation of six existing fire stations, and the rebuilding of one fire station at its current location will provide the infrastructure to help meet this goal.

The major investment in Public Safety infrastructure included in this CIP is possible because the voters in San José supported investments in these facilities. On March 5, 2002, 71.7% of voters approved Measure O, the "9-1-1, Fire, Police, Paramedic and Neighborhood Security Act" Neighborhood Security Act Bond Measure. This bond measure authorized the City to issue General Obligation Bonds in an amount not to exceed \$159 million to fund both Police and Fire Department capital improvements. All of the projects funded by the Neighborhood Security Act Bond are scheduled to be underway during this five-year period.

In the 2007-2011 CIP, the budgets for many of the Public Safety Bond projects were increased to address recent cost escalation. Total fire station increases amounted to \$8.5 million, and increases to the Driver Safety Training, Police Substation, and West and South Community Policing Centers totaled \$2.5 million. These increases were mitigated through the use of interest from bond proceeds and the Bond Contingency Reserve. The Bond Contingency Reserve was created in 2002-2003 by allocating 10% from each project to assist in ensuring that early costs, for elements such as property acquisition and existing facility renovations, would not result in insufficient funding for projects planned for the latter years of the program. Given this rationale, it was important to retain a portion of the Contingency Reserve. After the adjustments in the 2007-2011 CIP, \$6.0 million remains in the Bond Contingency Reserve.

Following are the Public Safety Bond projects in the Adopted CIP:

- South San José Police Substation
- Driver Safety Training Center
- 9-1-1 Communications Dispatch Center
- South, East, and West Community Policing Centers
- New Fire Stations 34 (Berryessa), 35 (Cottle and Poughkeepsie), and 37 (Willow Glen)
- Rebuild Fire Station 2 (Alum Rock Avenue)
- Relocate Fire Stations 12 (Calero), 17 (Cambrian), 19 (Piedmont), 21 (White Road), and 25 (Alviso)
- Relocate Station 24/Construct Station 36 (Silver Creek/Yerba Buena)
- Fire Training Center Improvements
- Fire Station Upgrade

2006-2007 ADOPTED BUDGET MESSAGE

CAPITAL BUDGET OVERVIEW (CONT'D.)

Capital Program Overview by City Service Area (Cont'd.)

Public Safety CSA (Cont'd.)

A turnkey Fire Station on Communications Hill is currently scheduled to be constructed in 2006-2007 and operational in 2007-2008. The CIP includes funding from developers for the associated apparatus and equipment. The CIP also includes funding from the Fire Construction and Conveyance Tax Fund and the General Fund to support many of the infrastructure needs in the Fire Department, including fire apparatus replacement and repair, facilities improvements, hose replacement, emergency response maps, handheld radios, heavy rescue airbags, traffic control equipment, general tools and equipment, computer replacement, records management, and data analysis.

Transportation and Aviation Services CSA

The Transportation and Aviation Services CSA includes the Airport, Parking, and Traffic Capital Programs.

Airport Capital Program: The Adopted Airport Capital Program represents another significant change from the program presented in the 2006-2010 CIP. On November 15, 2005, the City Council approved revisions to the implementation of the Airport Master Plan following a three-day workshop held in September with Airport stakeholders and the City's aviation financial consultant, Ricondo and Associates. Two key findings resulted from this workshop: first, air passenger demand volume originally projected for the year 2010 (17.6 million) is now projected to be reached in 2017 and second, the continued implementation of the Master Plan needs to be limited to \$1.2 to \$1.5 billion. Input from a variety of stakeholders was used to develop a facility that will meet the community and customers' needs as well as keep costs low.

The \$417.8 million Terminal Area Development, Phase I is the largest project in the Adopted CIP. This project includes Terminal A improvements, the first half of Terminal B, a Temporary Terminal C passenger processing facility, the demolition of Terminal C, roadway improvements, landscaping and signage. A number of these projects, which are anticipated to be a part of a design-build contract, are scheduled for award in fall 2006. The Airport CIP includes several other major projects including the completion of the North Concourse, a consolidated rental car facility, public parking improvements, and airfield improvements.

Parking Capital Program: This program maintains and improves existing facilities, upgrades and replaces both on-street and off-street parking equipment, and develops parking facilities.

A Parking Management Plan (PMP) was developed in 2001 to address both short-term and long-term parking needs. Since its approval, the priority, need, and schedules of specific projects identified in the PMP have been significantly impacted by the downturn in the economy as well as by changes in the supply and demand for parking. In the fall of 2005, the City Council directed staff to update the PMP to reflect the current and future supply/demand, review the free parking

2006-2007 ADOPTED BUDGET MESSAGE

CAPITAL BUDGET OVERVIEW (CONT'D.)

Capital Program Overview by City Service Area (Cont'd.)

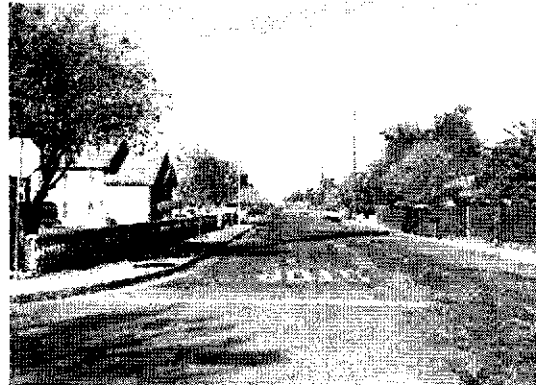
Transportation and Aviation Services CSA (Cont'd.)

program, and to recommend parking priorities for the next five years. After review by the Downtown Parking Board, the updated plan will be presented to the City Council in fall of 2006.

The Adopted CIP includes funding for the 2nd and San Carlos Street Garage Seismic Upgrade project; to implement Phase II of the Parking Guidance System that will include roadway signs to direct motorists to the parking facilities; to continue replacing the Parking Revenue Control System at several garages and lots; and to perform ongoing facility improvements.

Traffic Capital Program: The mission of the Traffic Capital Program is to implement a safe, efficient, and environmentally sensitive surface transportation system, consistent with the goals and policies of the City's General Plan. In the 2007-2011 Adopted Traffic CIP, \$242.3 million is allocated for the purposes of expanding and enhancing the transportation system. These resources are programmed to ensure that the transportation system supports the economic competitiveness of San José and provides residents with safe and attractive street facilities in their neighborhoods.

The investments approved as part of the 2007-2011 Adopted CIP include funding for the build-out of the major street network (\$19.1 million); enhancements to the environment (\$1.4 million); maintenance activities (\$43.7 million); an array of operations and safety projects at the neighborhood level, including traffic calming, bicycle and pedestrian facilities, and new traffic signals (\$52.7 million); rehabilitation projects (\$12.6 million); funding to support the City's contribution to regional highway and transit systems (\$6.4 million); and planning and engineering for local and regional projects (\$21.2 million); and reserves and transfers (\$82.9 million).



Towers Lane

During 2004-2005, the Santa Clara Valley Transportation Agency (VTA) updated its 30-year regional transportation master plan referred to as Valley Transportation Plan 2030 (VTP 2030). The plan includes an inventory of projects eligible for future regional transportation grant funding. To support the City's Council-adopted priorities in the VTP 2030, a reserve was first established in the 2005-2009 CIP in the amount of \$11.3 million to begin to provide necessary local matching funds. In both the 2006-2010 CIP and the 2007-2011 CIP, additional funding has been allocated to this reserve, which now totals \$24.9 million. Several of the investments in the Adopted CIP provide advance engineering to bring projects to a state of readiness to help them compete for regional funding. This strategy of proactively planning to leverage new State and federal funds is a continuation of the Traffic Program's successful record in leveraging significant grant funds by investing in upfront planning.

2006-2007 ADOPTED BUDGET MESSAGE

CAPITAL BUDGET OVERVIEW (CONT'D.)

Capital Program Overview by City Service Area (Cont'd.)

Transportation and Aviation Services CSA (Cont'd.)

The Adopted CIP also includes \$5.3 million in one-time funds from the General Fund to be used to address a portion of the significant backlog of transportation maintenance needs. The funding has been allocated to street resurfacing (\$3.0 million), traffic safety enhancements (\$1.8 million), and neighborhood appearance improvements (\$500,000).

Strategic Support

The Strategic Support CSA includes the Civic Center, Communications, Municipal Improvements, and the Service Yards Capital Programs.

Civic Center Capital Program: The Civic Center Capital Program is responsible for constructing the new City Hall and associated parking facilities. City Hall includes approximately 530,000 square feet of office and public space. Major components of this project include an 18-story office tower, a council chamber wing, an open public plaza with a rotunda, plus a 372-vehicle underground parking garage to serve the visiting public and some staff. Occupancy of this new facility occurred in mid-2005 with the off-site garage scheduled for completion in the fall of 2006.

The 2007-2011 Adopted CIP includes funding to complete the off-site parking garage as well as the purchase of furniture, fixtures, and equipment for City Hall. In addition, \$2.2 million from interest earnings on the Civic Center Construction Bonds has been allocated to City Hall capital enhancements, such as access and safety improvements, cable/fiber connections to public safety facilities, improved signage, and completion of office spaces. A large share of the interest earnings (\$4.3 million) has also been allocated to a Reserve for Neighborhood Capital Improvements. These funds will be used for city-wide neighborhood capital projects.

Communications Capital Program: The Communications Capital Program provides reliable, necessary public safety and non-public safety-related communications equipment for all City employees that require this equipment for their jobs. A total of \$5.9 million is allocated in this CIP to the Equipment Replacement and Upgrade project, which entails replacing a large portion of the communications equipment over the next five years. In addition, \$4.8 million is programmed for the COPS 2003-2004 Interoperable Communications Grant that will upgrade the microwave network for the City of San José and Santa Clara County and establish links in north, south, and west areas of Santa Clara County to provide complete communications coverage.

Municipal Improvements Capital Program: The Municipal Improvements Capital Program provides capital improvements for City facilities that are not funded in other capital programs. The General Fund typically supports these projects. The 2007-2011 Adopted CIP includes the following ongoing allocations: HP Pavilion Repairs (\$825,000); Fuel Tank Monitoring (\$302,000); Closed Landfill Compliance (\$1.4 million); and Unanticipated/Emergency Maintenance (\$1.1 million).

2006-2007 ADOPTED BUDGET MESSAGE

CAPITAL BUDGET OVERVIEW (CONT'D.)

Capital Program Overview by City Service Area (Cont'd.)

Strategic Support CSA (Cont'd.)

Funding has also been rebudgeted from 2005-2006 in both the General Fund (\$4.8 million) and the Redevelopment Capital Projects Fund (\$550,000) to complete existing capital projects.

In addition, a new General Fund project (Facilities Infrastructure Maintenance Backlog) in the amount of \$1 million was approved to start addressing the significant backlog of deferred maintenance in City facilities.

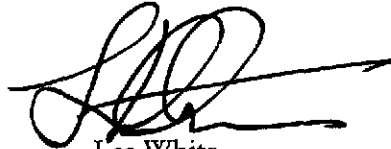
Service Yards Capital Program: The objective of the Service Yards Capital Program is to maintain and improve the existing conditions at the Service Yards by implementing projects to reduce safety hazards, increase efficiencies, and provide necessary equipment and materials for operations. While ongoing funding is allocated to address general capital improvement needs, the majority of funding in this capital program is set aside for the Central Service Yard Phase II project. This project began in 2005-2006 and is expected to be completed in 2007-2008.

CONCLUSION

This 2006-2007 Adopted Operating Budget successfully closed a \$34.9 million dollar shortfall with a combination of ongoing reductions, the strategic use of reserves and one-time dollars, the approved extension of the ECSS Fee, and with fee increases designed to continue moving the City closer to full cost recovery in a number of areas. In addition, the coordinated efforts of every CSA identified opportunities to be more efficient while reducing costs. We believe the mix of solutions represented a sound and fiscally prudent approach to balancing the budget. Unlike the past several years, we were able to minimize the use of one-time solutions with the added benefit that this reduces future year shortfalls. We have minimized the number of positions to be eliminated and selectively added positions to meet critical needs. In addition, for the first time in more than five years we have been able to set aside significant dollars to begin addressing a substantial backlog of unmet infrastructure maintenance needs that have grown significantly over the past few years. We have maintained our commitment to provide essential services and to keep the City Council's commitment to neighborhoods. While it is clear that we are in a "delicate" economic environment (with high office vacancies, continued weak job growth, a softening housing market, and rising fuel costs), we are nonetheless showing signs of now emerging from the prolonged economic downturn. This plan maintains the sound financial discipline that has allowed us to manage through the long recession.

2006-2007 ADOPTED BUDGET MESSAGE

I have been very impressed with the strong commitment and high degree of professionalism that I have found in the workforce since my return to San José. I want to express my appreciation to all of the dedicated City employees who have worked closely with the Administration as we moved through this budget process. In particular, I want to acknowledge and express my sincere appreciation to the many employees at all levels of the organization, but most especially to the hard working administrative staff in City departments as well as the entire Budget Office, who contributed to the preparation and production of this budget document.

A handwritten signature in black ink, appearing to read 'Les White', with a long horizontal stroke extending to the right.

Les White
City Manager